

# Ongoing monitoring of the employer covenant

The strength of the employer covenant can change materially over a short period of time, which could have significant implications for the scheme's investment and funding strategy. Trustees should monitor the covenant regularly between formal assessments so they can act quickly if needed. The frequency and depth of monitoring should be proportionate to the circumstances of the scheme and employer.

## Key points for consideration

Key covenant factors to monitor will vary by employer but could include the following:

- ▶ Material changes in current and forecast affordability of contributions to the scheme.
- ▶ Changes to the group structure directly affecting the employers or other entities, which have a material impact on the covenant (such as a subsidiary of an employer).
- ▶ Any plans to refinance or to raise external financing in the group.
- ▶ Dividend payments (or analogous extractions of value such as changes in intra-group debt) above a specified level.
- ▶ Adverse movement in the employer's key performance indicators.
- ▶ Reputational damage to the employer's brand.
- ▶ Significant changes in the employer's industry, such as the merger of two of the employer's competitors, regulatory changes or material technological innovation.
- ▶ Governance or key personnel changes to the employer.

The following is an example of a monitoring framework illustrating possible triggers for action.

## Facts:

- ▶ The trustees of a scheme are concerned about the risk of a future weakening in the covenant as a result of changes in its industry.
- ▶ In such an event, they believe that the level of investment and funding risk would need to be reviewed and that higher contributions from the employer may be required.
- ▶ The employer's dividend policy is to distribute 50% of post-tax profits to its parent company.

The trustees could set up a monitoring framework which would include trigger points which they have identified would indicate or lead to a material weakening of the covenant and would result in the trustees taking action.

## Triggers

Some of the triggers which may lead the trustees to react include:

- ▶ Payment of a dividend in excess of 50% of post tax profit.
- ▶ A 10% fall in the employer's revenue relative to the time of the last valuation.
- ▶ A change in credit rating.
- ▶ Loss of a customer which represents more than 5% of the business.
- ▶ A change in ownership of the employer or its group.
- ▶ A change in the price of a key commodity (eg oil).
- ▶ Non-renewal of a key contract.
- ▶ Inability to refinance debt twelve months before scheduled maturity (for significant debt obligations).

These triggers are given as examples only. Appropriate triggers and associated actions will depend on the specific circumstances of the scheme and the employer.

Although such actions may represent additional calls on the employer's resources, they would reduce the risk that the scheme poses to the employer and the likelihood that adverse changes in the scheme could make an already difficult situation worse.